Stranded Gas Hearings

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What Agreements Must Be Reached Before the Federal Energy Regulatory Commission Weighs In on Tariff Issues

Dan Ives, Vice President and Principal, Lukens Energy Group, Inc., presenter for Dept. of Law, June 16, 2004.

DANIEL IVES, Vice President and Principal, Lukens Energy Group, Inc., informed the committees that he is representing the Alaska Department of Law. He said he would address the specific question regarding the agreements that must be reached before FERC weighs in on tariff issues. To answer that question, he provided a brief evolution of the natural gas transportation market and new pipeline capacity planning, specifically focusing on the open season process. [Throughout his presentation he referred to a packet of information from the Lukens Energy Group, which is contained in the committee packet.] He explained that in the mid 1980s FERC issued Order 436, which [required] open-access non-discriminatory transportation for those parties that sought to provide transportation. As Mr. Palmer mentioned earlier, quite a number of market centers have been developed in Alberta. The Alaskan gas would come through the aforementioned area and flow down to Chicago through the Northern Border Pipeline, the Alliance pipeline, and the Great Lakes Gas Transmission pipeline. On the West Coast there is the PGT pipeline, which brings the volumes down to Los Angeles and San Diego. Mr. Ives highlighted that the opening up of the pipeline markets has begun to create vibrant market centers. Market centers typically have interconnections of multiple pipes and there may also be processing plants and access to gas storage facilities. All of this is the result of the unbundling of the sales and transportation of natural gas. Therefore, the market became very robust as market centers were created around the country. He mentioned the Henry Hub, which he referred to as ground zero for natural gas pricing in the Lower 48.

MR. IVES explained that with the issuance of Order 636 the open access order was taken one step further by requiring mandatory unbundling of the sales and transportation of natural gas and related services, such as storage, peaking service, gathering, and processing. As the market centers evolved, much activity has occurred with price risk management. Mr. Ives highlighted that with the implementation of Order 636, all of the pipelines in the country were required to completely redo their tariffs and implement the open-access service. The aforementioned process was managed on a settlement process basis, in which FERC was very active. He said that FERC has been very active in regulating the natural gas markets and helping to facilitate the implementation of its policies. Order 636, he noted, also provided for a capacity release program in which shippers could release their capacity. Therefore, the parties, on an open access fully disclosed basis, could offer up capacity for the highest bidder.

MR. IVES turned to FERC's Order 637 in 2000. Order 637 simply provided a number of enhancements to Order 636. For instance, the scheduling provisions for natural gas were enhanced and thus provided shippers the ability to fine-tune daily nominations. Moreover, the order provided enhanced capacity segmentation rights such that customers could take the contract path from the wellhead to the burner tip, section it off, and release the capacity to those wanting to pay for it. Furthermore, there was increased informational reporting requirements for interstate pipelines, which resulted in enhanced information for firm, interruptible, storage, and capacity release transactions and for the Index of Customers. Therefore, Order 637 provided enhanced transparency to the contracting process.

MR. IVES recalled the Natural Gas Act of 1938 (NGA), which provided for the regulation of natural gas companies. One of the provisions of NGA requires companies to obtain a certificate of public convenience and necessity (CPCN) from FERC prior to the construction, extension, or acquisition and operation of pipeline facilities. Part of the process requires the applicant to demonstrate the need for the new capacity, which is typically demonstrated by the evidence of contracts, market studies, and reserve studies. He noted that the exact process with regard to determining the need isn't mandated by FERC. Therefore, it's incumbent upon the pipeline operator or project sponsor to put together a market study to demonstrate the need for the project and that it's been offered on a nondiscriminatory basis to all.

MR. IVES proceeded to provide a quick overview of the typical FERC application process. Typically, the pipeline would hold an open season to determine a market need, then select a pipeline route and perhaps some alternative routes. The pipeline would identify landowners, start easement negotiations, and hold public meetings with the public and the various agencies involved. The environmental surveys would begin and ultimately file an application with FERC. However, FERC has modified the process such that it has implemented a process to speed up the certification process by FERC being involved earlier in the process and working with the companies on a prefiling basis. The aforementioned, he opined, would be particularly important in the Alaskan project considering the magnitude, the number of agencies involved, and the countries involved. The process is fairly complex, and therefore any help in compressing the timeline will be invaluable.

MR. IVES moved on to the open season process, which is discussed on page 8 of the booklet he provided to the committees. He explained that the open season process provides shippers the opportunity to express their interest in transportation capacity on a pipeline. The process is open to all shippers who want to provide natural gas supplies or take gas deliveries on the pipeline. He noted that many producers hold firm capacity on interstate pipelines in order to move the gas from the production area to the market centers. A number of the "LDC" type customers purchase gas at market centers rather than at the production area. He highlighted that the open season process is held at the discretion of the pipeline. At least one of the agreements filed under the Stranded Gas Pipeline Act has mandated an open season process for its application. He explained that typically the open season projects are posted on the Internet web sites of the pipeline sponsors. He recalled one of the Stranded Gas applications that he reviewed, which required that six months prior to an open season there would be notice such that the entire world would know about an upcoming open season. The aforementioned is encouraging. Pages 10-12 of the Lukens Energy Group booklet specifies what may be contained in an open season announcement, which may include descriptions of alternative projects.

MR. IVES pointed out that an alternative in the open season process would be a nonbinding letter of interest. A pipeline would "pre-float" the open season process and letters of interest are sent out for response. After that process, the full open season process would occur. He noted that new projects are typically conditioned on the pipeline's ability to timely obtain FERC certification without material modifications to the project and upon completion of the construction. The aforementioned indicates the need to have the regulators involved at all levels and very early in the process. He turned attention to page 15, which has an example of rates from an open season document for Kinder Morgan. The example illustrates that the open season was shopped with various alternatives for various levels of interest. He noted that economies of scale could be seen in the chart. He also noted that FL&U rates, the fuel use and unaccounted for gas, can be a significant factor in the era of $6 gas. The aforementioned plays into the construction of the pipe and whether one would put in more pipe or more compression.

MR. IVES moved on to precedent agreements, which is an interim contract that is a legally binding contract with terms, conditions, penalties for nonperformance, and mandates for performance. The ultimate mandate is that when FERC issues the certificate on terms that are generally consistent with the open season, the shipper will ultimately sign a service agreement at the various rates and quantities for the various receipt and delivery points. Typically, the precedent agreement outlines what the shipper wants, the path, the quantities, the agreement to enter into a service agreement, and the pipeline's agreement. Mr. Ives pointed out that there are "conditions precedent" that must be done. The pipeline must obtain rights-of-way for the route on acceptable terms and conditions, FERC's approval with the issuance of a certificate by a date certain upon terms and conditions consistent with the precedent agreement. Furthermore, the pipeline's board of director and the shipper's board of director must approve entering into the project and the service agreement, respectively. The shipper must also satisfy credit requirements, the standards for which have tightened significantly. Moreover, the project must remain economically viable. Precedent agreements also include efforts and timing, termination rights for the shipper and the pipeline, a termination fee, and other provisions. The ultimate goal is to have a project that's approved with the shipper under the service agreement under the pipeline's tariff. He mentioned that a precedent agreement would typically include force majeure, assignment, a most favored nations clause, governing law, and notices.

MR. IVES highlighted that the precedent agreements typically mirror the pipeline service agreement. In reviewing the project and whether to authorize it, FERC reviews the firm commitments by the shippers pre-construction and pre-certification in order to determine the market interest in the project. Furthermore, FERC may also have market studies done in order to review the global market versus what specific shippers are willing to purchase. The FERC may also review the supply end of the market as well in order to determine whether the project is well supported in that area. One of FERC's conditions in the filing process is that the pipeline or sponsor must file the agreements in support of the project as one of its exhibits.

MR. IVES turned to FERC's policy statement. The FERC did have a presumption for the roll-in pricing of expansions of pipelines, assuming they didn't go above a 5 percent limit. In 1999, FERC changed its presumption from roll-in pricing to incremental pricing, which essentially left the pipeline responsible for the cost of new capacity if it weren't fully utilized. With respect to project enhancements, if the incremental rate exceeds the recourse rate, then the incremental rate is charged. However, if the incremental rate is less than the recourse rate, the recourse rate is charged and the project is rolled in. If nothing bars the aforementioned, he expected that policy to be applied to the Alaskan project as well. Mr. Ives pointed out the board's goals and objectives for certificate policy, which are listed on page 23 of the Lukens Energy Group booklet.

MR. IVES moved on to page 25 of the Lukens Energy Group booklet, which discusses the certification process. He informed the committees that 18 CFR [Code of Federal Regulations] provides the basic regulations for FERC and Part 157.6 describes the general content of applications for each project. He explained that essentially one would file a mini rate case. Ultimately one would show who would pay and under what rate schedules, and the contracts that support this. Certain information regarding the applicant and landowners. Mr. Ives related a story that illustrated that FERC is very interested in what [the average citizen] thinks about running pipes. He pointed out that page 27 specifies the exhibits are required to be filed with each application. Exhibit I, market data, would contain the requirement for the contracts and the market studies to be filed as evidence that the project is bona fide. Exhibit P contains the tariff and all the effective rate schedules. Exhibit P will also provide information relating whether the proposal of a new rate is the result of negotiation, a cost-of-service rate, or the involvement of discounting. One must also consider the competitive factors and was the rate made available to all similarly situated customers. Therefore, Exhibit P is fairly comprehensive. In addition to FERC's traditional filing process, FERC has recently adopted the National Environmental Policy Act (NEPA) prefiling process in which FERC and the related agencies will be involved much sooner. He noted that many of the landowner relationships and the environmental scoping studies will be started much earlier in the project; the government will be brought in early to expedite the process, identify the critical issues, and determine how to resolve those.

MR. IVES directed the committees to page 34 of the Lukens Energy Group booklet, which has a timeline. The timeline illustrates that under the expedited process, the order is issued much earlier. In this case, about six to seven months are shaved off the process. Furthermore, the scoping studies are conducted much earlier in the process. Under the expedited process, FERC is involved in a much earlier stage of the process. After going through the entire process, FERC has wide latitude with regard to setting the terms and condition of the certificate. The FERC will review and analyze the application and supporting information. The FERC may require the applicant to make changes to the project such as alternate routing in order to ameliorate environmental and/or landowner concerns. Other changes may be in regard to configuration and sizing, based on variance in routing or design load, or rates to reflect the final costs. Moreover, FERC may require that there be a rate-refresher after a certain period of time, which has typically been three years.

SENATOR BUNDE turned to the timeline and surmised that the worst-case scenario would result in a two-year process whereas an expedited process would be a year process. He assumed the aforementioned would relate to a typical pipeline. However, Alaska's project would be a large project that he didn't guess would be typical. Senator Bunde inquired as to the time involved in actually dealing with a

project the magnitude of Alaska's project.

MR. IVES agreed that Alaska's project is of a large scale and scope. One of the factors that helps expedite the process is that this project would predominantly deal with the operations within one state versus multiple states. Furthermore, he related his understanding that FERC intends on being involved in this project early.

MR. IVES highlighted that there have been agreements signed by Canada and the United States that will promote cooperation between the two countries in terms of expediting the project. Furthermore, he opined that any enabling legislation may put FERC under considerable pressure, either by law or by inference, to speed their process. "So I think you're going to see a 'all hands on deck' effort by the [FERC]; I do have a certain amount of confidence in them, having worked with them for a number of years," he said.

SENATOR BUNDE remarked: "But in the worst-case scenario, two to three years."

MR. IVES replied: "Yeah, I think you're right."